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Natasha Mulleneaux

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## THE FAILURE TO PROVIDE ADEQUATE HIGHER EDUCATION TAX INCENTIVES FOR LOWER-INCOME INDIVIDUALS

by

Natasha Mulleneaux\*

### I. INTRODUCTION

Traditionally, the fundamental goal of federal involvement in higher education has been to encourage and provide access to all individuals regardless of income level or race.<sup>1</sup> Broad access to higher education is important for the nation's long-term economic growth.<sup>2</sup> Lower-income individuals, however, are increasingly hesitant to attend college due to a combination of increased tuition rates and the erosion of need-based assistance.<sup>3</sup>

The Taxpayer Relief Act of 1997 ("the Act"),<sup>4</sup> enacted August 5, 1997, contained nearly \$100 billion in educational incentives for the years 1997--2007.<sup>5</sup> The Act comes at a time when the level of education needed for productive employment is increasing and the higher education sector is suffering from a

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\* Member of the California State Bar, 1998. B.S. (Accounting) Arizona State University, 1995; J.D., University of Arizona, 1998. Ms. Mulleneaux is employed by Ernst & Young LLP in San Jose, California where she works with the Mergers & Acquisitions Tax Group. She has previously written for Taxes - The Tax Magazine.

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<sup>1</sup> *Education and Training Tax Provisions of the Administration's Fiscal year 1998 Budget Proposal: Hearings Before the House Comm. On Ways and Means*, 105th Cong., (1997) (statement of James B. Appleberry, President of the American Association of State Colleges and Universities).

<sup>2</sup> See also *Saving Incentives for Higher Education: Hearings Before the Senate Finance Comm.*, 105th Cong. (1997) (statement of Lawrence H. Summers, Deputy Secretary for the Department of Treasury).

<sup>3</sup> See Appleberry, *supra* note 1; see also R. Paul Guerre, Note, *Financial Aid in Higher Education: What's Wrong, Who's Being Hurt, What's Being Done*, 17 J.C. & U.L. 483, 512 (1991).

<sup>4</sup> Pub. L. No. 105-34, 111 Stat. 788 (codified in scattered sections of 26 U.S.C.).

<sup>5</sup> H.R. CONF. REP. NO. 105-220, 105<sup>th</sup> Cong., 1<sup>st</sup> Sess. (Estimated Budget Effects of the Conference Agreement on the Revenue Provisions of H.R. 2014, the "Taxpayer Relief Act of 1997").

shortfall in funding.<sup>6</sup> The Act's incentives, however, do not benefit a broad range of individuals. Seventy-five percent of its cost provides tuition tax credits<sup>7</sup> which primarily benefit middle-income taxpayers who would attend college regardless of the credits.<sup>8</sup> Thus, the Act fails its purpose of increasing college enrollment levels and does not uphold the primary goal of federal involvement in higher education.<sup>9</sup>

This Article suggests that the cost of the education incentives in the Taxpayer Relief Act of 1997 is better spent on programs which more effectively subsidize lower-income families' educational expenses. Part II discusses the benefits of higher education for the nation and individuals, and it provides a brief history of the federal government's role in funding higher education. Part III discusses the effect that increasing tuition costs and eroding grant programs likely have on college attendance. Part IV outlines the educational incentives contained in the Taxpayer Relief Act and critiques the usefulness of the tuition tax credits, and Part V proposes the elimination of these credits.

## II. BENEFITS OF HIGHER EDUCATION

### A. *Effect of Higher Education Attainment on the Nation and Individuals*

Although educational authority rests with the states,<sup>10</sup> the federal government encourages and specifically assists educational activities that are considered in the national interest.<sup>11</sup> The promotion and financial assistance of

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<sup>6</sup> See Summers, *supra* note 2; see Joseph L. Dionne & Thomas Kean, *Breaking the Social Contract: The Fiscal Crisis in Higher Education*, THE VIRGINIAN PILOT AND THE LEDGER STAR, Sept. 18, 1997, at B10.

<sup>7</sup> H. R. CONF. REP. NO. 105-220, *supra*, note 5.

<sup>8</sup> See *supra*, note 1 (statement of Lawrence E. Gladieux, Executive Director for Policy Analysis at the College Board).

<sup>9</sup> *Id.*; see *infra* text accompanying notes 65-68.

<sup>10</sup> See U.S. CONST. amend. X. The Tenth Amendment reserves all powers not specified in the Constitution to the states. Because the Constitution is silent on the issue of education, public education is effectively reserved to state control.

<sup>11</sup> See discussion *infra* Part II.B.; see generally U.S. Const. art. I, § 8 (granting Congress the power to tax and provide for the common defense and general welfare of the U.S.). This Constitutional provision has served as a legal foundation for the passage of specific education laws. H.C. HUDGINS, JR. & RICHARD S. VACCA, LAW AND EDUCATION: CONTEMPORARY ISSUES AND COURT DECISIONS (4th ed. 1995). See also, JOINT COMMITTEE OF TAXATION, PRESENT LAW AND BACKGROUND RELATING TO THE MARRIAGE TAX PENALTY, EDUCATION TAX INCENTIVES, THE ALTERNATIVE MINIMUM TAX AND EXPIRING TAX PROVISIONS, 106<sup>th</sup> Cong. (Comm. Print 1999).

higher education is clearly in the national interest, as higher education (1) increases the nation's productivity and wealth, (2) assists in social progress and (3) increases the prosperity of individuals.<sup>12</sup>

The U.S. economy benefits greatly from educational attainment.<sup>13</sup> For example, it is estimated that for every dollar the government invested in education under the G.I. Bill of Rights,<sup>14</sup> the nation received between \$5.00 and \$12.50 in benefits.<sup>15</sup> Additionally, the Bureau of Labor estimates that the rise in the average educational attainment of the workforce accounted for one-fifth of the annual growth in productivity between 1963 and 1992.<sup>16</sup> Advances in knowledge accounted for over one-half of growth in the nation's wealth throughout the 20th Century.<sup>17</sup> As these statistics indicate, the U.S. needs a well-trained and educated workforce to continue to compete in the global marketplace.<sup>18</sup> The economy also benefits from increased revenues. Individuals with a baccalaureate degree earn 43 percent of all federal personal income taxes while constituting only 23 percent of tax filers.<sup>19</sup>

Educational attainment promotes social progress.<sup>20</sup> Higher education is "the means of upward mobility and the great equalizer in our society."<sup>21</sup> Those with

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<sup>12</sup> *Id.*

<sup>13</sup> See Summers, *supra* note 2; see also *Higher Education Reauthorization: Hearings Before the House Subcomm. On Postsecondary Education, Training and Life-Long Learning*, 105th Cong., (1997) (statement of Richard W. Riley, Secretary of the U.S. Department of Education).

<sup>14</sup> See *infra* notes 38-39.

<sup>15</sup> See Augustus F. Hawkins, *Becoming Preeminent in Education: America's Greatest Challenge*, 14 HARV. J.L. & PUB. POL'Y 367, 374 (1991) (citing STAFF OF JOINT ECONOMIC COMM., SUBCOMM. ON EDUCATION AND HEALTH, 100TH CONG., A COST-BENEFIT ANALYSIS OF GOVERNMENT INVESTMENT IN POST-SECONDARY EDUCATION UNDER THE WORLD WAR II G.I.BILL 1 (1988), reprinted in *Future of Head Start: Hearing Before the Subcomm. On Education and Health of the Joint Economic Comm.*, 101st Cong., 93, 94 (1990)); see also Appleberry, *supra* note 1 (noting that much of America's post-war economic success is attributable to the G.I. Bill of Rights).

<sup>16</sup> See Summers, *supra* note 2.

<sup>17</sup> See *supra* note 1 (statement of Stanley O. Ikenberry, President of the American Council on Education).

<sup>18</sup> See *supra* note 2.

<sup>19</sup> See *supra* note 1.

<sup>20</sup> See *supra* note 1 (statement of Stanley O. Ikenberry, President of the American Council on Education).

<sup>21</sup> See *supra* note 1.

some college education are more likely to vote and to engage in volunteer activities than those with only a high school diploma or less.<sup>22</sup> Additionally, higher education results in lower unemployment, and lessens the need for unemployment compensation and public funding of health care.<sup>23</sup>

Individuals who attend college are likely to earn higher incomes, thereby increasing their prosperity.<sup>24</sup> In 1993, the mean monthly income for all workers with a bachelor's degree was on average 90 percent greater than that of comparable workers with only a high school degree.<sup>25</sup> Furthermore, a college degree is increasingly a necessity as service-related jobs have come to dominate in the workplace.<sup>26</sup> The Department of Labor predicts that by 2005, the number of jobs requiring a Master's, Bachelor's or Associate's degree will jump by 25 percent.<sup>27</sup>

### *B. History of the Federal Government's Role in Funding Higher Education*

The founders of the United States desired class mobility and a society in which even those from the poorest of families could achieve success and affluence if they worked hard.<sup>28</sup> In accordance with this ideal, the federal government's policy with respect to higher education has been "to promote and equalize access to all individuals, especially for those with the fewest resources."<sup>29</sup> Thus, increased access to higher education for lower-income individuals measures the extent to which the federal government has achieved this goal.<sup>30</sup>

The Morrill Act of 1862<sup>31</sup> marked the formal entrance of the federal government into the higher education arena.<sup>32</sup> The Morrill Act created land grant schools "to teach such branches of learning as are related to agriculture and the

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<sup>22</sup> *Id.*

<sup>23</sup> See *supra* note 1 (statement of Stanley O. Ikenberry, President of the American Council on Education).

<sup>24</sup> See *supra* note 2.

<sup>25</sup> See U.S. DEPARTMENT OF COMMERCE, STATISTICAL ABSTRACT OF THE U.S., 116th ed., tbl. 244 (1996).

<sup>26</sup> See Dionne & Kean, *supra* note 6.

<sup>27</sup> See *supra* note 1 (statement of Stanley O. Ikenberry, President of the American Council on Education).

<sup>28</sup> See *supra* note 1.

<sup>29</sup> See *supra* note 1 (statement of Lawrence E. Gladieux, Executive Director for Policy Analysis at the College Board).

<sup>30</sup> See *supra* note 1.

<sup>31</sup> July 2, 1862, Ch. 130, 12 Stat. 503 (codified as amended at 7 U.S.C. §§ 301-308).

<sup>32</sup> Guerre, *supra* note 3, at 512.

mechanic arts."<sup>33</sup> The establishment of the schools was based on population, demonstrating an attempt by the government to provide equal access to education.<sup>34</sup> Higher education subsequently became more of a necessity for individual and social progress;<sup>35</sup> however, lower-income individuals were unable to participate in the higher education system.<sup>36</sup> Eventually, an increased demand for financial assistance provided a greater justification for federal involvement in higher education.<sup>37</sup> After World War II, the passage of the Servicemen's Readjustment Act of 1944<sup>38</sup> (also known as the G.I. Bill of Rights) provided educational opportunities to millions of World War II veterans and later military service.<sup>39</sup> Finally, the Higher Education Act of 1965<sup>40</sup> established grants and low-interest loans for college students (known today as the Pell Grant program and the Stafford Loan program).<sup>41</sup> The Pell Grant program assists lower-income individuals in attending college,<sup>42</sup> whereas the Stafford Loan program focuses on the needs of students from middle-income families.<sup>43</sup> In fiscal year 1996, higher education programs received over \$14.8 billion from the federal government.<sup>44</sup>

Historically, the Internal Revenue Code has provided little tax relief for educational expenses.<sup>45</sup> There are three major exceptions: (1) certain educational

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<sup>33</sup> Morrill Act of 1862, *supra* note 30.

<sup>34</sup> Hawkins, *supra* note 15, at 372-73. Prior to the establishment of land grant schools, American colleges and universities had been perceived as elitist institutions. Guerre, *supra* note 3, at 513.

<sup>35</sup> Guerre, *supra* note 3, at 512.

<sup>36</sup> Hawkins, *supra* note 15, at 373. Until the early part of the Twentieth Century, the federal government was involved mainly in promoting higher education. *Id.*

<sup>37</sup> Guerre, *supra* note 3, at 512.

<sup>38</sup> June 22, 1944, ch. 268, 58 Stat. 284 (codified as amended in scattered sections of the U.S.C.).

<sup>39</sup> See *supra* note 1.

<sup>40</sup> Pub. L. No. 89-329, 79 Stat. 1219 (current version at 20 U.S.C. 1001-1146a).

<sup>41</sup> *Id.*

<sup>42</sup> *Id.* at 1232, tit. IV, part A, § 401(a).

<sup>43</sup> See generally *id.* at 1236, tit. IV, Part B.

<sup>44</sup> See U.S. DEPARTMENT OF EDUCATION, NATIONAL CENTER FOR EDUCATION STATISTICS, DIGEST OF EDUCATION STATISTICS, tbl. 354 (November 1996).

<sup>45</sup> See generally H.R. Conf. Rep. No. 105-220, 105<sup>th</sup> Cong., 1<sup>st</sup> Sess. (1997) (noting that "taxpayers generally may not deduct education and training expenses"); see also Jay Katz, *The Deductibility of Educational Costs: Why Does Congress Allow the IRS to Take Your Education So Personally?*, 17 VA. TAX REV. 1 (1997) (noting that educational expenditures are generally nondeductible and arguing that such expenditures should be deductible).

expenses may qualify as deductible business expenses under § 162,<sup>46</sup> (2) an employee may be entitled to an exclusion for employer-provided educational benefits,<sup>47</sup> and (3) income earned on qualified U.S. savings bonds that is used to pay higher education expenses is excludable from income.<sup>48</sup> Generally, however, tax laws treat educational expenses as nondeductible personal expenditures.<sup>49</sup>

### III. TUITION COSTS AND GRANT PROGRAMS

The attainment of higher education by individuals from all socioeconomic groups is critical for progress and prosperity on both a national and individual level.<sup>50</sup> However, students from lower-income families still enroll in higher education at significantly lower rates than students from more affluent families.<sup>51</sup>

A 1994 study, conducted by the U.S. Department of Education, shows that even when lower-income students enroll in college, they are much less likely to attain a degree than their higher-income peers.<sup>52</sup> The study tracked the progress of first-time postsecondary students seeking a Bachelor's degree enrolling in the 1989-90 academic year. Of those students from a low socioeconomic status, only 25.8 percent had attained their Bachelor's degree by 1994 while 49.1 percent had dropped out.<sup>53</sup> In contrast, of the students from a high socioeconomic status, 61.3 percent attained a Bachelor's degree by 1994, while only 19.0 percent had left school with no degree.<sup>54</sup>

Increased tuition rates and the erosion of spending power in grant programs may help to explain why students from less affluent families have low rates of enrollment and completion.<sup>55</sup> Between 1980 and 1995, average tuition at public four-year colleges increased by 92 percent.<sup>56</sup> This jump far surpassed the four

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<sup>46</sup> Treas. Reg. § 1.162-5.

<sup>47</sup> I.R.C. § 117.

<sup>48</sup> I.R.C. § 135 (applying to savings bonds issued after 1989).

<sup>49</sup> See generally Katz, *supra* note 45.

<sup>50</sup> See discussion *supra* Part II.A.

<sup>51</sup> Riley, *supra* note 13. Ninety-one percent of 1992 high school graduates from the highest socioeconomic quartile (based on income and education) entered college within two years, compared to only 49 percent of students in the lowest quartile. *Id.*

<sup>52</sup> U.S. DEPARTMENT OF EDUCATION, *supra* note 44, tbl. 309.

<sup>53</sup> *Id.*

<sup>54</sup> *Id.*

<sup>55</sup> See *supra* note 1 (statement of Stanley O. Ikenberry, President of the American Council on Education).

<sup>56</sup> See *supra* note 2. During the same time period, average tuition rose by 75 percent for public 2-year colleges. *Id.* See also U.S. Department of Education, *supra* note 44, tbl. 311

percent increase in median family income during the same time period.<sup>57</sup> As tuition rates have increased, federal need-based grant programs have declined in purchasing power.<sup>58</sup> In 1995, the maximum Pell Grant award (\$2,340) covered less than 40 percent of the average cost of attendance at a four-year public institution and only 15 percent of the average cost at a private institution.<sup>59</sup> Since 1980, the purchasing power of the Pell Grant has fallen 37 percent.<sup>60</sup> One economist estimates that Pell Grants have been underfunded by approximately \$6 billion.<sup>61</sup>

As might be expected, lower-income individuals are disproportionately affected by and sensitive to the increase in tuition rates and decline of grant programs.<sup>62</sup> The most needy families have been forced to finance their educational expenses through increased borrowing.<sup>63</sup> Financing an education through borrowing increases anxiety, which likely decreases college attendance rates of lower-income individuals.<sup>64</sup>

#### IV. EDUCATIONAL INCENTIVES IN THE TAXPAYER RELIEF ACT

##### A. Purpose of Educational Incentives

In the 1997 State of the Union address, President Clinton pledged to "make the 13th and 14th years of education--at least two years of college--just as universal

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(average undergraduate tuition and fees and room and board rates by type of institution from 1964-65 to 1995-96) & tbl. 313 (graduate and professional tuition from 1987-88 to 1995-96).

<sup>57</sup> See, *supra* note 2.

<sup>58</sup> See *supra* note 1.

<sup>59</sup> See *supra* note 1 (statement of Lawrence E. Gladieux, Executive Director for Policy Analysis at the College Board); see generally Dep'ts of Labor, Health and Human Services, and Education, and Related Agencies Appropriations Act, Pub. L. No. 103-333, 108 Stat. 2539 (1995).

<sup>60</sup> See *Reauthorization of Student Assistance Programs: Hearings Before the Senate Comm. On Labor and Human Resources*, 105th Cong. (1997) (statement of Joel V. Harrell, Director of Financial Aid, University of Tennessee at Chattanooga (quoting the Washington Post)).

<sup>61</sup> See *supra* note 2 (statement of David W. Breneman, University Professor and Dean, Curry School of Education, University of Virginia). Another estimate indicates that if the Pell Grant had kept up with inflation, the maximum grant would be \$5,500 in 1997. *Pell Grant Increase is Good Start*, STAR TRIBUNE, Nov. 24, 1997, at 12A.

<sup>62</sup> See *supra* note 1.

<sup>63</sup> *Id.*

<sup>64</sup> *Id.*



in America by the Twenty-First Century as a high school education is today."<sup>65</sup> The Taxpayer Relief Act of 1997 contains educational incentives intended to help fulfill this promise.<sup>66</sup> The legislative history indicates the Act's purposes are (1) to assist lower and middle-income taxpayers with the expenses of higher education<sup>67</sup> and (2) to provide "much needed tax relief" for middle-income working families.<sup>68</sup>

## B. Explanation of Major Provisions

### 1. Hope Credits.

Eligible taxpayers are entitled to a nonrefundable income tax credit known as the Hope Scholarship credit.<sup>69</sup> For each eligible student, the Hope credit is available up to \$1,500 per year.<sup>70</sup> Generally, an eligible student is an individual (1) enrolled in a degree, certificate or other program leading to a recognized educational credential at an eligible educational institution<sup>71</sup> and (2) pursuing a course of study on at least a half-time basis.<sup>72</sup> Additionally, a felony drug offense conviction disqualifies the student.<sup>73</sup> Qualified tuition and related expenses paid by the taxpayer for the first two years of a student's higher education qualify for the credit.<sup>74</sup> Qualified tuition and related expenses include tuition and fees required for the enrollment or attendance of a student at an eligible educational institution for

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<sup>65</sup> President William J. Clinton, *President's Report on the State of the Union* (1997).

<sup>66</sup> See generally Katz, *supra* note 45, at 96-101 (describing the educational incentives of the Act); see also I.R.S. Notice 97-60, 1997-46 I.R.B. at 8-17 (1997) (providing guidance on the educational incentives of the Act).

<sup>67</sup> See H.R. REP. NO. 105-148, 105<sup>th</sup> Cong., 1<sup>st</sup> Sess. (1997).

<sup>68</sup> *Id.* at 283 (Statement of the House Comm. On the Budget on the Revenue Reconciliation Act of 1997).

<sup>69</sup> I.R.C. § 25A see generally Prop. Reg. 1.25 A-3 (regarding HOPE credit).

<sup>70</sup> I.R.C. § 25A(b)(1)).

<sup>71</sup> An eligible educational institution is defined as an institution described in § 481 of the Higher Education Act of 1965 and which is eligible to participate in a program under title IV of this Act. I.R.C. § 25A(f)(2). Under these rules, eligible institutions are generally accredited post-secondary educational institutions offering credit toward a bachelor's degree, associate's degree, or another recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also are eligible educational institutions. The institution must be eligible to participate in Department of Education student aid programs. H.R. REP. NO. 105-148, *supra* note 67, at 344.

<sup>72</sup> I.R.C. § 25A(b)(3)(B).

<sup>73</sup> I.R.C. § 25A(b)(2)(D).

<sup>74</sup> I.R.C. § 25A(b)(2)(C).

courses of instruction at that institution.<sup>75</sup> The student may be (1) the taxpayer, (2) the taxpayer's spouse or (3) a dependent of the taxpayer with respect to whom the taxpayer is allowed a dependency exemption.<sup>76</sup> The amount of eligible tuition and expenses are reduced by the amounts paid for the benefit of the student which are (1) a qualified scholarship, (2) an educational assistance allowance and (3) a payment (other than a gift, bequest, devise or inheritance) for educational expenses which are excludable from gross income.<sup>77</sup> The credit phases out for taxpayers with modified adjusted gross income of \$40-50,000 (\$80-100,000 for joint return filers).<sup>78</sup>

## 2. Lifetime Learning Credits.

The Lifetime Learning credit is available in an amount equal to 20% of qualified tuition and related expenses<sup>79</sup> paid each year by the taxpayer for a student's education. Up to \$5,000 of expenses can qualify for the 20% credit; after 2002, the 20% credit may be used for \$10,000 of expenses.<sup>80</sup> In contrast to the Hope credit, the Lifetime Learning credit is available for an unlimited number of years for both undergraduate and graduate-level (including professional degree) expenses.<sup>81</sup> Furthermore, the Lifetime Learning credit may be used for expenses incurred<sup>82</sup> to acquire or improve job skills, whether the student is enrolled on a full-time, half-time or less than half-time basis.<sup>83</sup> As with the Hope credit, the Lifetime Learning credit phases out for taxpayers with modified adjusted gross income of \$40-50,000 (\$80-100,000 for joint return filers).<sup>84</sup> A taxpayer may not utilize both the Hope and Lifetime Learning credits for the same student in the same taxable year.<sup>85</sup> However, a student may benefit from different credits in different years.<sup>86</sup>

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<sup>75</sup> I.R.C. § 25A (f)(1).

<sup>76</sup> *Id.*

<sup>77</sup> I.R.C. § 25A(g)(2).

<sup>78</sup> I.R.C. § 25A(d).

<sup>79</sup> I.R.C. § 25A(f)(1). *See generally* Prop. Reg. 1.25A-4 (regarding Lifetime Learning credit).

<sup>80</sup> I.R.C. § 25A(c)(1).

<sup>81</sup> H.R. CONF. REP. NO. 105-220, *supra* note 45, at 346.

<sup>82</sup> I.R.C. § 25A(f)(2). Amounts must be paid to an eligible educational institution. *See supra* note 71.

<sup>83</sup> I.R.C. §§ 25A(c)(2)(B) & 25A(b)(3)(B); H.R. CONF. REP. NO. 105-220, *supra* note 45, at 346-47.

<sup>84</sup> I.R.C. § 25A(d).

<sup>85</sup> I.R.C. § 25A(c)(2)(A) & H.R. CONF. REP. NO. 105-220, *supra* note 45 at 346.

<sup>86</sup> I.R.C. § 25A(c)(2)(A).

### C. Criticisms of the Hope and Lifetime Learning Credits

Lower-income taxpayers derive significantly less benefit from the Hope and Lifetime Learning credits than middle and higher-income taxpayers.<sup>87</sup> This inequality occurs for several reasons.<sup>88</sup> First, many lower-income taxpayers do not have enough (if any) of the income tax liability needed to benefit from the nonrefundable credits.<sup>89</sup> Accordingly, low-income individuals on the margin of entering college receive little benefit from the nonrefundable credits.<sup>90</sup> Second, for those lower-income taxpayers who are able to use the credits, the timing of the tax benefit "reduces its practical value to families trying to make ends meet."<sup>91</sup> Tax relief is not provided until up to a year after college expenses are paid,<sup>92</sup> and lower-income taxpayers may not have adequate resources to pay expenses upfront. Third, the credits cover only a portion of tuition at four-year state schools; this amount may not be enough to influence lower-income individuals to attend college.<sup>93</sup> Fourth, other grant assistance, on which lower-income students tend to rely,<sup>94</sup> is not taken into account when calculating the credit amount.<sup>95</sup> Because most of the students who benefit from the credits are from middle to higher-income families, the Hope and Lifetime Learning credits will not result in a significant increase in the number of students attending college. Such individuals would likely attend

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<sup>87</sup> See generally Gene Steuerle, *Straying From Tax Policy Principles*, 97 TNT 202-73 (Oct. 20, 1997) (noting that he knows of no one in the education field who claimed that the Taxpayer Relief Act of 1997 targets the most important educational needs); see *supra* notes 71 & 77 (noting that the credits completely phase out at modified adjusted gross income of \$50,000 for single taxpayers and \$100,000 for joint filers).

<sup>88</sup> See JOINT COMMITTEE OF TAXATION, 105<sup>th</sup> Cong., ANALYSIS OF PROPOSED TAX INCENTIVES FOR HIGHER EDUCATION (Comm. Print 1997) (noting that the credits will provide more benefit to higher-income taxpayers to lower-income taxpayers). See also, Thomas J. Kane, *Savings Incentives for Higher Education*, 51 NATL. TAX J. 609 (Sept. 1998).

<sup>89</sup> *Id.*

<sup>90</sup> Kane, *supra* note 88.

<sup>91</sup> See *supra* note 1 (statement of Lawrence E. Gladieux, Executive Director for Policy Analysis at the College Board).

<sup>92</sup> The credits are deducted on the tax return following the year the education expenses are paid. I.R.C. § 25A.

<sup>93</sup> In 1995, the average charge for tuition and fees at a four-year public college was \$2,982. U.S. DEPARTMENT OF COMMERCE, *supra* note 25 (Table 290).

<sup>94</sup> See *supra* note 1 (statement of Stanley O. Ikenberry, President of the American Council on Education).

<sup>95</sup> I.R.C. § 25A(g)(2).

college regardless of whether the credits were allowed.<sup>96</sup>

Furthermore, the credits may cause tuition rates to rise, as colleges may determine that the credits provide taxpayers with an ability to pay more.<sup>97</sup> Institutions that award need-based aid from their own funds are likely to consider the credits when they evaluate a family's ability to pay.<sup>98</sup> Under current law, the higher an individual's income, the less student aid the individual receives.<sup>99</sup> Because the credits lower taxes, after-tax income is raised.<sup>100</sup> Accordingly, a college may provide less assistance when the credits are taken into account.<sup>101</sup>

The Hope and Lifetime Learning credits render an already complex tax system even more complicated. New paperwork and forms are required in order to take advantage of the credits.<sup>102</sup> The complex eligibility requirements and their interaction with other variables is confusing.<sup>103</sup> For example, other grant assistance limits the availability of the credits.<sup>104</sup> One tax analyst suggests that the average

<sup>96</sup> See Riley, *supra* note 12.

<sup>97</sup> See *supra* note 2 (statement of David W. Breneman, University Professor and Dean, Curry School of Education, University of Virginia).

<sup>98</sup> See *supra* note 1 (statement of Lawrence E. Gladieux, Executive Director for Policy Analysis of the College Board). See also Kane, *supra* note 88, (noting that while a number of institutions have indicated they will allow families to retain the full benefit of the credits, administrators from other institutions have argued that these credits should be treated like any other source of family income.)

<sup>99</sup> See Jane Bryant Quinn, *Education Tax Credits May Be Offset by Aid Cutbacks*, THE DES MOINES REGISTER, Sept. 1, 1997, at 13.

<sup>100</sup> *Id.*

<sup>101</sup> Kenneth R. Miller, *How are New Tax Benefits, Old Tax Burdens Affecting Colleges and Universities?*, 98 TNT 166-55 (Aug. 27, 1998).

<sup>102</sup> John S. Barry, Economic Policy Analyst for the Heritage Foundation, in testimony before the Senate Finance Committee stated: "In poll after poll, Americans record the complexity of the federal income tax as a major concern. The costs of this complexity are enormous. Each year Americans spend more than 5.4 billion hours and \$157 billion filling out their federal tax forms. President Clinton's plan [the Hope credit] would add to this complexity by carving out yet another tax credit that would require additional paper work and additional forms." *Family Savings and Paying for College: Hearings Before the Senate Finance Comm.*, 105th Cong. (1997) (statement of John S. Barry, Economic Policy Analyst at the Heritage Foundation).

<sup>103</sup> See *New Tax Law's Education Breaks Have Lots of Fine Print*, SAN FRANCISCO CHRONICLE, Aug. 25, 1997 at 1C. See also Kane, *supra* note 88 (discussing the difficulty of coordinating among the separate tax incentives).

<sup>104</sup> I.R.C. § 25A(g)(2).

household now needs its own financial planner and accountant.<sup>105</sup>

Traditionally, higher education is subsidized by the federal government through direct expenditures (as opposed to tax expenditures) such as Stafford Loans and Pell Grants.<sup>106</sup> There are distinct advantages in using direct expenditures instead of tax expenditures. For example, it is easier to comprehend the effect that direct expenditure programs have on individuals and the budget.<sup>107</sup> Furthermore, such programs do not complicate the Internal Revenue Code.<sup>108</sup> Finally, in the context of higher education spending, direct expenditures are more efficient than tax expenditures because the benefit received by lower-income taxpayers is needed concurrently with the payment of applicable expenses.<sup>109</sup>

#### *D. Explanation of Other Provisions*

##### 1. Education IRAs.

An Education Individual Retirement Account ("education IRA") is a trust created exclusively for the purpose of paying the higher education expenses of a designated beneficiary.<sup>110</sup> The beneficiary includes neither contributions to nor earnings of the IRA in gross income.<sup>111</sup> However, the contributor to the IRA receives no deduction for the contributions.<sup>112</sup> Contributions must be made (1) in cash, (2) before the beneficiary reaches 18 years of age and (3) in an aggregate

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<sup>105</sup> See Barry, *supra* note 102.

<sup>106</sup> See Steuerle, *supra* note 87 (noting that the Department of Education should handle educational money, and not the IRS).

<sup>107</sup> See Marlo Roache, *Credits' Benefits May Be Limited; Experts Doubt That Clinton's 'Scholarships' Will Make College Universally Available or Will Help Middle-Class Families as Projected*, SARASOTA HERALD-TRIBUNE, Aug. 2, 1997, at 1A. Policymakers may chose to spend through tax expenditures so they may boast they are cutting taxes rather than increasing spending on a program; however, the budget effect is exactly the same. *Id.*

<sup>108</sup> *Id.*

<sup>109</sup> See *supra* note 1 (statement of Lawrence E. Gladieux, Executive Director for Policy Analysis at the College Board); see *supra* note 107 and *infra* note 110 and accompanying text (noting that the Hope and Lifetime Learning credits do not provide tax relief until after the payment of college expenses).

<sup>110</sup> I.R.C. § 530(b).

<sup>111</sup> I.R.C. § 530(a). The education IRA is subject to the taxes imposed by I.R.C. § 511 (relating to the tax imposed on unrelated business income of charitable organizations). *Id.*

<sup>112</sup> I.R.C. § 530.

amount of \$500 or less per year beneficiary.<sup>113</sup> The \$500 contribution phases out for taxpayers with modified adjusted gross income of \$95-110,000 (\$160-170,000 for joint filers).<sup>114</sup> If the beneficiary's qualified higher education expenses in a year equal or exceed total education IRA distributions for that year, the distributions are entirely excluded from the beneficiary's gross income.<sup>115</sup> Qualified higher education expenses include tuition, fees, books, and "reasonable" room and board costs.<sup>116</sup> If education IRA distributions in a given year exceed higher education expenses, the amount includible in gross income bears the same ratio to the amount which would be includible<sup>117</sup> as the expenses bear to the distribution.<sup>118</sup>

## 2. State Prepaid Tuition Plans.

Internal Revenue Code § 529, enacted as part of the Small Business Job Protection Act of 1996, provides that a state or local government may establish and maintain a qualified state tuition program.<sup>119</sup> Such a program allows individuals to (1) purchase tuition credits which entitle the designated beneficiary to the waiver of payment of qualified higher education expenses<sup>120</sup> or (2) make contributions to an account to be used toward the qualified higher education expenses of the designated beneficiary of the account.<sup>121</sup> In general, section 529 provides that none of the distributions from such programs are included in the gross income of a

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<sup>113</sup> I.R.C. § 530(b)(1)(A). An exception to the \$500 limit is made in the case of rollover contributions. *Id.*

<sup>114</sup> I.R.C. § 530(c).

<sup>115</sup> I.R.C. § 530(d)(2)(A).

<sup>116</sup> I.R.C. § 530(b)(2)(A). Qualified higher education expenses are defined as tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a designated beneficiary at an eligible educational institution. *Id.* (amending I.R.C. § 529(e)(3)(A)). Reasonable room and board costs may not exceed the minimum amount included in the cost of attendance at the institution applicable to the student under § 472 of the Higher Education Act of 1965. *Id.* (amending I.R.C. § 529(e)(3)(B)).

<sup>117</sup> This refers to the amount includible under the annuity rules of I.R.C. § 72(b).

<sup>118</sup> I.R.C. § 530(d)(2)(B)). It appears that the drafters mistakenly provided for the inclusion of the earnings portion of a distribution that the beneficiary uses for qualified higher education expenses. Instead, in accordance with congressional intent, the statute should provide for the exclusion of the earnings portion of the distribution used for educational expenses. See Research Institute of America, *RIA's Complete Analysis of the Taxpayer Relief Act of 1997*, para. 403 at 99 (1997).

<sup>119</sup> I.R.C. § 529(b)(1). See generally Prop. Reg. 1.529-1 through 1.529-6 (regarding QSTP).

<sup>120</sup> I.R.C. § 529(e)(3). See *supra* note 95 (defining qualified higher education expenses).

<sup>121</sup> I.R.C. § 529(e)(3).

contributor to, or beneficiary of the program.<sup>122</sup> When a distribution is made, the beneficiary pays tax on a portion of the amount attributable to earnings.<sup>123</sup> These qualified programs allow taxpayers to "lock in tomorrow's tuition at today's rates."<sup>124</sup> Unlike the Hope and Lifetime Learning credits, § 529 includes reasonable room and board costs<sup>125</sup> as qualified higher education expenses.<sup>126</sup>

### 3. Deductibility of Student Loan Interest.

The Internal Revenue Code specifically provides that personal interest is nondeductible.<sup>127</sup> Generally, personal interest is any interest that is not trade or business interest, investment interest, or home mortgage interest.<sup>128</sup> However, individuals with college loans may now take an above-the-line deduction for interest paid on such loans.<sup>129</sup> The \$1,000 deduction allowed for 1998 increases by \$500 each year through 2002.<sup>130</sup> The deduction applies to new loans, as well as to existing loans where fewer than 60 monthly payments have been made.<sup>131</sup> The deduction is phased out for taxpayers with modified adjusted gross income of \$40-55,000 (\$60-75,000 for joint filers).<sup>132</sup>

### 4. Increase in Pell Grant Award.

Under separate legislation, the maximum Pell Grant award was increased by \$300 to \$3,000 for the 1998-99 school year.<sup>133</sup> This amount is the maximum annual allowance that eligible lower-income recipients may receive.<sup>134</sup>

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<sup>122</sup> I.R.C. § 529.

<sup>123</sup> I.R.C. § 529 and Reg. § 1.529-3.

<sup>124</sup> *See Family Savings and Paying for College: Hearings Before the Senate Finance Comm.*, 105th Cong. (1997) (statement of John S. Barry, Economic Policy Analyst at the Heritage Foundation) (quoting Peter Mezereas, Executive Director of Massachusetts state tuition plan).

<sup>125</sup> *Id.*

<sup>126</sup> I.R.C. § 529(e)(3).

<sup>127</sup> I.R.C. § 163(h).

<sup>128</sup> I.R.C. § 163(h)(2). *See generally* Prop. Reg. 1.221-1 (regarding deductible education interest).

<sup>129</sup> I.R.C. §§ 221 & 62(a)(17).

<sup>130</sup> I.R.C. § 221(b)(1).

<sup>131</sup> I.R.C. § 221(d).

<sup>132</sup> I.R.C. § 221(b)(2).

<sup>133</sup> Departments of Labor, Health and Human Services, Education, and Related Agencies Appropriations Act, Pub. L. No. 105-78, 111 Stat. 1467 (1998).

<sup>134</sup> *Id.*

## V. PROPOSALS

The federal government's involvement with educational policy is traditionally focused on providing greater access to higher education, which in turn provides benefits to the nation.<sup>135</sup> Thus, educational incentives for taxpayers should be concerned with providing the most equity in dollars spent, and not necessarily on providing middle-income taxpayers with tax relief.<sup>136</sup> To actually expand opportunity in higher education, the \$75 billion allocated to the Hope and Lifetime Learning credits would be better used in existing aid programs such as grants, loans and work-study programs.<sup>137</sup> Research has shown that the most effective way to ensure access and encourage graduation among financially disadvantaged students is to supplement their college costs with need-based grants.<sup>138</sup> Need-based assistance gives the dollars to students when tuition bills are due, not months later. For a lower-income student, receiving grant dollars before expenses must be paid may mean the difference between attending college or not. Additionally, without need-based assistance, lower-income individuals are forced to incur increased debt, which also may be the deciding factor in the choice of whether to attend college. Need-based aid does not eliminate assistance to middle-income taxpayers, as existing aid programs help both lower and middle-income families based on need.<sup>139</sup>

The increase in the maximum Pell Grant award is encouraging; however, the value of the grant is still 27 percent less than it was worth in 1980.<sup>140</sup> Furthermore, "[the] much-needed \$300 increase in the maximum Pell Grant . . . does not balance the scales compared to a \$1,500 tax credit."<sup>141</sup> Therefore, the credits should be eliminated, with these revenues allocated to a greater increase in the maximum Pell Grant or other financial aid awards. Ideally, incentives to attend

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<sup>135</sup> See discussion *infra* Part II.

<sup>136</sup> Compare discussion *supra* Part IV.A.

<sup>137</sup> See *supra*, note 1 (statement of Lawrence E. Gladieux, Executive Director for Policy Analysis at the College Board). Cf. Miller, *supra* note 101 (noting that direct expenditure programs are the preferable method to broaden access to higher education, but arguing that such programs are not practical due to antipathy and opposition towards federal spending programs and federal involvement in education).

<sup>138</sup> See *Fiscal Year 1988 Request for Postsecondary Education Programs: Hearings Before the Senate Finance Comm.*, 105th Cong. (1997) (statement of David Longanecker, Assistant Secretary for Postsecondary Education).

<sup>139</sup> *Id.*

<sup>140</sup> See *supra* note 60 (statement of Joel V. Harrell, Director of Financial Aid, University of Tennessee at Chattanooga).

<sup>141</sup> See *supra*, note 1 (statement of Lawrence E. Gladieux, Executive Director for Policy Analysis of the College Board).



college should be provided to all individuals. Middle and higher-income families need reasonable alternatives to finance college more than they need the modest subsidies of the Hope and Lifetime Learning credits.<sup>142</sup> The expansion of Stafford and PLUS loans have done much to accomplish this goal,<sup>143</sup> and plans that encourage savings for college, such as education IRAs or state prepaid tuition plans further assist such families with their college financing needs.<sup>144</sup> These programs are more responsive to the needs of middle and higher-income families than the Hope and Lifetime Learning credits.<sup>145</sup>

## VI. CONCLUSION

A fundamental goal of the federal government is to provide access to higher education for every citizen; the nation as a whole benefits greatly from and is dependent on educating its citizens. Thus, recent tuition increases and the decline of need-based aid programs necessitates more educational incentives geared particularly towards lower-income taxpayers. The Taxpayer Relief Act of 1997 does little to help lower-income individuals, nor does it encourage a greater number of individuals to attend college; rather, it provides most of its educational benefits to those who will attend college anyway. The Act would better serve the nation's interest as well as comport with the traditional goals of the federal government by (1) eliminating the Hope and Lifetime Learning credits from the Act and (2) using resulting revenues to increase the maximum Pell Grant award.

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<sup>142</sup> See *supra* note 2 (statement of David W. Breneman, University Professor and Dean, Curry School of Education, University of Virginia).

<sup>143</sup> *Id.* See also Michael Ferry, *Changes in Student Loan Regulations*, 50 BUS. LAW. 1135 (1995) (noting that the typical defaulting student loan debtors are lower-income individuals); Riley, *supra* note 13 (noting that the student loan default rate is declining).

<sup>144</sup> See *supra* text accompanying notes 107-123. See generally *supra*, Kane, note 88 (noting that Education IRAs may not have a large effect on families savings for college because most families have access to less costly sources of capital).

<sup>145</sup> See generally *supra*, Kane, note 88. See e.g., JOINT COMMITTEE OF TAXATION, *supra* note 11.